IS "LINKAGE" BROKEN?
NO SYMMETRY OF SPECULATION IS

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Letter to a critic of my deflation theory

Dear Mr. East,

Thank you for your letter and for your interest in my work. You challenge my conclusion that rising bond prices may eventually force commodity prices to fall. We are talking about the mechanism of “linkage” here, the phenomenon that the price level and the interest-rate structure are linked, that is to say, apart from leads and lags they rise and fall together. This is a subject on which I have been writing for many years. Please allow me to repeat my argument in support of linkage.

My theory is in terms of the dynamics of money-flows from one market to another. In particular, I consider inflows/outflows of money to/from the bond market and the commodity market. I define deflation as the *net* flow of money from the commodity market to the bond market. This doesn’t preclude money from flowing to the commodity market causing prices to rise even under deflation. But since on balance more money flows to the bond market, bond prices rise more, and the corresponding fall in the rate of interest is the dominant fact of the economy, not the rise in commodity prices, however conspicuous the latter may be. Price indices may or may not catch the effect of the net outflow of money from the commodity market. Inflation is defined *mutatis mutandis*.

Now it is my contention that, as a result of the manner in which the central bank injects new money into the economy, and also as a result of Keynesian contra-cyclical monetary policy whereby the central bank combats falling prices, as well as rising interest rates, through open market purchases of bonds, there are two instances of bias, breaking the symmetry of speculation and thereby distorting the economy.

First, there is bias favoring bond speculation vis-à-vis commodity speculation. The symmetry between the two markets breaks down because whenever the central bank intervenes, it is always in the bond market, never in the commodity market. Speculators know this, and take advantage of it. They can reduce the risks in bond speculation, or even eliminate it altogether through adroitly forestalling central bank intervention, that is to say, buying bonds just before the central bank does. Even small-time speculators who cannot hope to fine-tune their purchases to forestall the central bank, prefer the bond to the commodity market where they feel sheltered in the shadow of that powerful operator whose moves they can, as a copy-cat, mechanically follow. This explains why speculative activity in bonds and interest-rate derivatives has been snow-balling for the past 35 years. There was no organized bond speculation before 1971 while the dollar was on the gold exchange standard. Speculators want to have a free ride and they've got it in bonds. There is no free ride in the commodity market because, as we have seen, there is no central bank intervention there. Of course, this does not mean that speculators abandon the commodity market *en bloc* in favor of bonds. Scarcity and oversupply still occur and continue to offer profit opportunities to the nimble speculator. He will calculate the risk-reward factor and place his bets accordingly on the long or short side of the commodity market. But it will not be a free ride. It is the speculator who must bear the full burden of risk. Less nimble speculators will congregate in the bond market where they can get away without bearing the full burden of risk.

Second, there is bias favoring bull speculators in the bond market vis-à-vis the bears. Speculation in the bond market is far from symmetric. This is so because the central bank is on the long side of the bond market most of the time. Its visits to the short side are rare and hurried, mainly for window-dressing purposes and, *horribile dictu*, to deceive the market. All the basic operations such as the periodic augmentation of the money supply, combating falling prices or rising interest rates (the two major threats to the economy as seen by the central bank) involve purchases of bonds in the open market, not sales. The playing field is not level. The bulls are helped by open market operations of the central bank at the expense of the bears. The behavior of speculators reflects this bias. They buy bonds whenever the central bank buys, but refrain from selling when the central bank sells. If they sell, it is for profit-taking. They hardly ever go naked short. It would be suicidal to defy the central bank in shorting the bond market.

Combining these two instances of bias, which break the symmetry of speculation thereby distorting its role in the economy, we could schematize data as follows. There are four basic position that a speculator can take:

1. Long in bonds

2. Short in bonds
3. Long in commodities
4. Short in commodities

The odds that the speculator take any one of these basic positions should *ceteris paribus* be the same. But because of the bias introduced by open market operations of the central bank, the odds favor position number one: long in bonds. In equilibrium speculative money will still flow, namely, it flows into bonds. There is a prejudice favoring lower interest rates.

The managers of the regime of irredeemable currency are either unaware of or tend to ignore the bias they have themselves introduced into speculation. As a consequence, central bank intervention in the bond market tends to be counter-productive. For example, in trying to combat falling prices the central bank buys bonds, hoping that the new money will flow to the commodity market and stem the price slide. But speculators have a better idea. They take the new money to the bond market where they buy in tandem with the central bank. As a result interest rates fall, and linkage will cause commodity prices to fall further. The central bank's intervention has made deflation worse, not better. An example is Japan where enormous increases in the money supply, designed to combat falling prices, has only caused prices to fall more. How could the central bank make such a colossal blunder? Because it is ignorant of linkage, and of the bias that its own open market operations create in speculation.

To recapitulate, there is a fundamental deflationary effect in the economy caused by central bank open market operations favoring, as it does, (1) bond as opposed to commodity speculation, (2) the long as opposed to the short side of the bond market. This effect reinforces deflation in the economy whenever it occurs. The net inflow of money to the bond market from the commodity market is expanded as risks in bond speculation on the long side of the market are reduced or eliminated. There is no corresponding effect to reinforce inflation, the net outflow of money from the bond market to the commodity market is not expanded, and risks in bond speculation on the short side, and in commodity speculation on the long side are not reduced. As a result, in a deflation (but not in an inflation) bond prices tend to be higher, and interest rates lower, than justified by economic conditions. This is what baffles the Bond King, and this is the "conundrum" of King Al. Be that as it may, this effect ought to be taken into account in reading deflationary signals, or in searching for inflationary signals.

Now let's turn to linkage, the phenomenon of commodity prices and interest rates moving together subject to leads and lags. We want to see how this is a consequence of the bias, breaking the symmetry between bond and commodity speculation, and between bull and bear speculation in bonds. The proposition that high and increasing prices cause higher (and low and decreasing prices cause lower) interest rates is not controversial as it is accepted by most economists. Therefore I shall focus attention on the case of interest rates being (1) low and falling, (2) high and rising.

In the first case bond prices are high and rising, as they would be in deflation. If there was no bias, then speculators would resist the rise and take profit in selling the bonds. But bias is introduced by the central bank's buying of bonds in an effort to combat deflation. Therefore speculators will let their profits ride. What is more, they will pyramid. Rather than opposing the central bank, they will join its buying spree with all what they have and finance their bond pyramiding through liquidating their holdings of commodities, causing prices to fall.

In the second case bond prices are low and falling as they would be in inflation. If there was no bias, then speculators would resist the fall and buy the bonds. But they find the risks unacceptable. They already have worrisome paper losses on their bond portfolio due to rising interest rates. They consider the possibility that the central bank may fail in its efforts to contain inflation. Central bank buying of bonds is their opportunity to cut losses and exit the bond market. So they feed their bonds to the central bank and use the proceeds to pyramid in commodities, causing prices to rise.

This concludes my explanation of linkage. I realize that my theory is counter-intuitive and raises eyebrows right and left. Please remember that we have been conditioned by financial journalists and academic observers to ignore the dynamics of the interaction between changes in the rate of interest and price changes in terms of the underlying money-flows. They work on the basis of the simplistic formula that a low rate of interest perks up speculation whereas a high rate dampens it. My theory goes far deeper than that. It takes speculation fully into account, including the choice confronting the speculator whether he wants to deploy his capital in the commodity market, or whether he wants to deploy it in the bond market. The simplistic formula is flawed, as it ignores the fact that speculation itself has a feedback-effect on interest rates.

It is unrealistic to assume, as most financial journalists do, that speculators don't take advantage of profitable opportunities in the bond market inadvertently created by central bank intervention. Actually they do, and have done so since the 1930's when the Fed first started using what has come to be known as open market operations, in line with Keynes' contra-cyclical monetary policy prescriptions. *It is not recognized in the existing economic literature that bullish bond speculation played a big role in prolonging and deepening the Great Depression.* Unfortunately, the deficient understanding of the Great Depression will result in a repetition of the mistakes and may be instrumental in bringing about a Second Great Depression, worse even than the first.

My critics suggest that, as prices and interest rates move in opposite directions, linkage has now been broken. Don't be hasty with your conclusions. It is possible that either the price level lags the interest rate structure, or the other way round. If either one forced the other to follow, then they would resume marching together once more. It is an open question whether they would march up, or they would march down. My guess is that, unless the world plunged into a full-scale war stretching supplies of commodities to the limit and destroying production facilities, they would march down, after commodity prices made an 'about-face', as they did in Japan. This guess is justified by the deflationary bias caused by central bank open market operations as explained above, and on the dynamics predicated upon it.

The deflationary bias in the economy is quite palpable. In spite of the reckless and record-breaking increases in the money supply under Alan Greenspan's watch, price increases have been moderate. Without the deflationary bias we should have had massive inflation.

Don't be fooled by Greenspan who is patting himself on the back in taking credit for turning inflation around through monetary policy that "cleverly mimics the gold standard". Greenspan is not unlike the surfer on the beach boasting that it was he who turned the tide back through skillful surfing.

A steep rise in American interest rates and the corresponding destruction of bond values, at a time when central banks around the globe are itching to dump the dollar, would be catastrophic. It would be a financial earthquake measuring 9.9 on the Greenspan scale. That is strong enough to demolish the international monetary system based on the irredeemable dollar. Moreover, through the domino effect, reinforced by competitive devaluations, it could wipe out the value of a lot of weaker currencies.

Greenspan knows this. He won't allow that to happen during the last nine months of his long tenure, if he can help it. Can he? You bet. How? Why, through conspiring with the Bank of Japan, of course. If they joined forces, they could mercilessly punish everybody who had the temerity to short the dollar and bonds, be they central bankers, bond kings, or individual speculators. But this is a topic for another letter.

Yours, etc.

Reference

Antal E. Fekete, *Causes and Consequences of the Kondratiev Long-Wave Cycle,* January, 2005